

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
INTERNALLY MANAGED AFFILIATE EQUITY INDEX FUNDS**

April 21, 2008

This Policy is effective immediately upon adoption and replaces the Pooled Standard & Poor's 500 Equity Index Fund – Internally Managed and the Deferred Compensation Standard & Poor's 500 Equity Index Fund – Internally Managed Policy documents.

I. PURPOSE

The CalPERS Total Fund Statement of Investment Policy, adopted by the CalPERS Investment Committee ("Committee"), sets forth CalPERS' overarching investment purposes and objectives with respect to all its investment programs.

This document sets forth the investment policy ("Policy") for the Internally Managed Affiliate Equity Index Funds - ("Funds" or "Portfolios"). Throughout this Policy, Funds and Portfolios are used interchangeably. The design of this Policy ensures that the investors, managers, consultants, and other participants selected by the California Public Employees' Retirement System ("CalPERS") take prudent and careful action while managing the funds. Additionally, use of this Policy assures sufficient flexibility in managing investment risks and returns associated with the Funds.

II. STRATEGIC OBJECTIVE

Obtaining broad equity market exposure achieved by closely tracking the designated [benchmark](#) indices is the strategic objective of the Funds.

The Funds shall be managed to accomplish the following:

- A. Enhance the total returns of the overall investment program for the participants of the Funds through broad U.S. stock market exposure at low cost; and,
- B. Deliver appropriate performance results within each fund relevant to its particular benchmark and provide broad stock diversification for the participants of the Fund.

III. RESPONSIBILITIES

- A. CalPERS' Investment Staff ("Staff") is responsible for the following:

1. All aspects of portfolio management including monitoring, analyzing, and evaluating performance relative to the appropriate benchmark.
 2. Reporting internally to senior management concerning the implementation of this Policy. Staff's report will be prepared monthly to include, but not be limited to the following:
 - a. Current market value of the Portfolios;
 - b. Performance of the Portfolios versus the benchmarks as reported by the master [custodian](#); and
 - c. [Performance attribution](#) analysis that accredits return to its causes.
 3. Reporting to the Committee as needed about the performance of the Funds. The General Pension Consultant is responsible for reporting quarterly to the Committee, as described in section III.B.
 4. Monitoring the implementation of, and compliance with, the Policy. Staff shall report material concerns, problems, changes, and all violations of Policies at the next Committee meeting, or sooner if deemed necessary. These reports shall include explanations of the violations and appropriate recommendations for corrective action.
 5. Purchasing only securities that are outlined in this Policy.
- B. The General Pension Consultant ("Consultant") is responsible for:

Monitoring, evaluating, and reporting quarterly, to the Committee, on the performance of the Funds relative to the benchmarks and Policy. The Consultant is contractually responsible for reporting non-compliance to the Committee.

IV. PERFORMANCE OBJECTIVE AND BENCHMARK

A. Performance Objective

Achieving the return for the broad equity market is the performance objective of the Funds. To accomplish this objective, using statistical models to approximate the return of the market, rather than replicate the full composition of the index, may be more cost effective.

It is expected that [return deviations](#) between the Portfolios and the designated benchmarks will be random. To account for the difference in

the methodology for calculating the returns of the benchmarks and the Portfolios, the resulting return deviation may require an adjustment. CalPERS shall set parameters in the statistical models it employs in such a manner that [tracking error](#) shall be within the following thresholds:

1. Deferred Compensation S&P 500 Index: [Forecasted tracking error](#) shall be within ± 20 basis points; realized returns should fall no more than 20 basis points below the benchmark over any 12 month period.
2. Pooled S&P 500 Index: Forecasted tracking error shall be within ± 20 basis points; realized returns should fall no more than 20 basis points below the benchmark over any 12 month period.
3. Deferred Compensation Small and Mid Cap Index: Forecasted tracking error shall be within ± 30 basis points; realized returns should fall no more than 30 basis points below the benchmark over any 12 month period.

B. Benchmark

Independent sources are responsible for maintaining the benchmarks as well as calculating and reporting the return of the benchmarks to CalPERS.

1. Deferred Compensation Index: The benchmark shall be the Standard & Poor's 500 Index (with dividends reinvested). This benchmark is [capitalization weighted](#) benchmark, designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries
2. Pooled Index: The benchmark shall be Standard & Poor's 500 Index excluding tobacco stocks (with dividends reinvested). This benchmark is a capitalization weighted benchmark designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries excluding tobacco stocks.
3. Deferred Compensation Small and Mid Cap Index: The benchmark shall be the Russell 2500 Index (with dividends reinvested). This benchmark is a capitalization weighted benchmark designed to measure the performance of a broad array of small and mid capitalization domestic companies. The benchmark excludes the 500 largest domestic firms as measured by the Russell index methodology. There may be significant differences in the industry

and sector exposures of this benchmark if compared to a large capitalization benchmark such as the Standard & Poor's 500.

V. INVESTMENT APPROACHES AND PARAMETERS

A. Investment Approaches

The Portfolios shall be managed in a structured fashion to achieve the stated performance objective. Structured investing can be achieved through replication or through an optimized, [sampled](#) approach to generate an actual Portfolio with risk characteristics closely resembling the benchmark. The actual implementation used for each Portfolio will be dependent on the specific characteristics of the applicable benchmark. A benchmark with a broader number of constituents and greater exposure to small capitalization securities will typically not be replicated due to liquidity and trading cost considerations.

Where an [optimization](#) approach is employed, a statistical risk model is used to define and decompose the Portfolio's risk exposures versus those of the benchmark. [Fundamental risk models](#) measure stock returns associated with industry and other fundamental factors such as domicile, price/earnings (P/E), yield, and [market capitalization](#). Such fundamental factors are referred to often as "[common factors](#)".

A common factor is an element of return that influences many securities and, hence, is a "common factor" in the returns on those securities. Based on the current Portfolio's exposure to industry, and common factors, the volatility of returns can be estimated. The information about volatility produced by a fundamental risk model can be used to evaluate Portfolio risk, decompose Portfolio risk according to common factor exposures, and evaluate how much of a Portfolio's return in a given period was due to each common factor exposure and how much was due to stock selection.

B. [Specific Risk](#) Parameters

Specific risk parameters shall limit the return deviation of the Portfolio versus the benchmark. Use of a number of different models shall ensure that the risk parameters are within an acceptable tolerance level to achieve the performance objectives. Since CalPERS may add or eliminate models, the specific risk parameters for each model are detailed in the Procedures Manuals.

Implementation of this program shall comply at all times with CalPERS' investment policies including, but not limited to, the following:

1. Statement of Investment Policy: Development of Derivatives Strategies; and
2. Proxy Voting Policies.

C. Permissible Securities

1. Equity and associated securities of U.S. publicly traded companies.
2. The Portfolio may hold securities not represented in the designated benchmark. Generally, these holdings in aggregate shall be limited to less than 3% of the Portfolio's total market value. Such holdings are justified by the following reasons:
 - a. Liquidity constraints or excessive transaction costs, such as those required to sell certain securities obtained from [corporate actions](#) or from past benchmark [reconstitutions](#); or
 - b. Are held as a proxy for a benchmark asset that is illiquid or unavailable; or
 - c. Expectation of inclusion in the benchmark at the next reconstitution.
3. [Derivative](#) securities, as detailed in Section VII.

D. Corporate Actions

Corporate actions (e.g., [tender offers](#), [mergers](#), [Dutch-auctions](#), or [spin-offs](#)) shall be handled on a case-by-case basis.

Companies which offer discount [Dividend Reinvestment Programs](#) (DRIP) and similar programs will be analyzed to determine if return enhancement can be added by participating in such programs.

E. [Rebalancing](#) and Trading Activity

The rebalance decision for any Portfolio is primarily based upon analysis of risk and potential performance deviation from the benchmark. Portfolio rebalancing shall be performed as necessary to maintain the Portfolio's risk characteristics in accordance with those of the benchmark. At a minimum, the Portfolio shall be reviewed monthly and at reconstitutions. The Portfolios will be analyzed to reduce [systematic](#) and [nonsystematic risk](#) while minimizing transaction costs.

A variety of trading techniques and liquidity sources shall be utilized to obtain best execution of the approved trade list.

Transaction cost analysis shall be performed and evaluated on a quarterly basis for monitoring trading efficiency as compared to that of a like universe. An outside vendor may prepare this analysis.

F. Strategy Monitoring

A monthly reporting package shall be prepared for each strategy by the Internal Equity staff assigned to manage the strategy. The reports to be included shall be those needed and appropriate to allow monitoring by more senior Internal Equity staff of the management process, risk acceptance and performance of each strategy. This reporting package may vary depending on the management process, benchmark and performance objective unique to each strategy and shall be described in the procedures manual.

The Consultant shall include strategy level information in their quarterly report to the Committee.

VI. CALCULATIONS AND COMPUTATIONS

Investors, managers, consultants, and other participants selected by CalPERS shall make all calculations and computations on a market value basis as recorded by CalPERS' Custodian.

VII. DERIVATIVES AND LEVERAGE POLICY

A. Strategies

The Fund may utilize financial [futures](#), [equity swaps](#) and [options](#) in the Portfolio for the following purposes:

1. Permitting the investment of dividends received;
2. Equitizing cash and dividends receivable;
3. Allowing adjustment of the Portfolio's risk characteristics in the most cost effective manner available;
4. Facilitating investment of cash flows related to contributions, withdrawals, or asset allocation compliance.

B. Justification

Justification for the above mentioned strategies includes the following:

1. Reducing transaction costs in comparison with the purchase of underlying securities;
2. Equitizing non-spendable cash exposures (e.g. dividend accruals) to get a highly correlated return on that component of the Portfolio;
3. Providing the ability to alter risk characteristics versus the benchmark without disrupting the underlying Portfolio or unnecessarily increasing turnover; and
4. Obtaining matched returns between the benchmark and the Portfolio through investment in custom equity swaps and currency forwards.

C. Restrictions

Restrictions on the above mentioned strategies include the following:

1. Writing [uncovered calls](#) is prohibited;
2. Leveraging is prohibited. The use of futures contracts as specified in this Policy will not constitute leverage;
3. With the exception of equity swaps and currency forwards, trading non-exchange traded derivatives is prohibited;
4. [Speculating](#) is prohibited;
5. Use of non-[CFTC](#) approved futures contracts is prohibited; and
6. Portfolio specific position limits will be established and monitored as detailed in the applicable procedures manual.

D. Permissible Derivatives

Derivatives utilized in the index Portfolio may include, but are not limited to the following:

1. Index futures;
2. Style futures;
3. Index options;

4. Currency forwards;
5. Equity swaps;
6. [Exchange Traded Funds](#) (ETF); and
7. [Closed End Funds](#).

E. Futures Commission Merchants (FCM)

Futures Commission Merchants are selected with the following broad range of criteria:

1. Low cost clearing and executing charges;
2. Securely capitalized firm;
3. Clear account statements and efficient reconciliation;
4. Responsive personnel;
5. Discrete and efficient operation;
6. Personal interview; and
7. Reference checks.

VIII. GLOSSARY OF TERMS

Key words used in this policy are defined in CalPERS' Master Glossary of Terms.

Deferred Comp S&P 500 Equity Index Funds – Internally Managed

Approved by the Policy Subcommittee: October 6, 2000

Adopted by the Investment Committee: November 13, 2000

Revised by the Policy Subcommittee: December 10, 2004

Approved by the Investment Committee: February 14, 2005

Pooled S&P 500 Equity Index Funds – Internally Managed

Approved by the Policy Subcommittee: October 6, 2000

Adopted by the Investment Committee: November 13, 2000

Revised by the Policy Subcommittee: December 10, 2004

Approved by the Investment Committee: February 14, 2005

Name Change to Internally Managed Affiliate Equity Index Funds

(Consolidation of Deferred Comp S&P Equity Index Funds and Pooled S&P 500 Equity Index Fund)

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